

REDACTED DECISION – DOCKET NUMBERS 12-268 PT AND 12-269 PT - By A.M. “FENWAY” POLLACK, CHIEF ADMINISTRATIVE LAW JUDGE – SUBMITTED for DECISION on DECEMBER 6, 2013 – DECISION ISSUED on JUNE 6, 2014

SYNOPSIS

TAXATION

SUPERVISION

GENERAL DUTIES AND POWERS OF COMMISSIONER; APPRAISERS

It is the duty of the Tax Commissioner to see that the laws concerning the assessment and collection of all taxes and levies are faithfully enforced. *See* W. Va. Code Ann. §11-1-2 (West 2010).

TAXATION

STRATEGIC RESEARCH AND DEVELOPMENT TAX CREDIT

LEGISLATIVE FINDING AND PURPOSE

In 2002 the West Virginia Legislature created the Strategic Research and Development Tax Credit, which was designed to “encourage research and development in this state and thereby increase employment and economic development . . .” W. Va. Code Ann. § 11-13R-2 (West 2010).

TAXATION

STRATEGIC RESEARCH AND DEVELOPMENT TAX CREDIT

AMOUNT OF CREDIT ALLOWED

The amount of the credit is “the greater of: (1) Three percent of the annual combined qualified research and development expenditure; or (2) Ten percent of the excess of the annual combined qualified research and development expenditure over the base amount.” W. Va. Code Ann. §11-13R-5 (West 2014).

TAXATION

STRATEGIC RESEARCH AND DEVELOPMENT TAX CREDIT

DEFINITIONS

Section 3 of Article 13R defines research and development as: “systematic scientific, engineering or technological study and investigation in a field of knowledge in the physical, computer or software sciences, often involving the formulation of hypotheses and experimentation for the purpose of revealing new facts, theories or principles or increasing scientific knowledge which may reveal the basis for new or enhanced products, equipment or manufacturing processes.” W. Va. Code Ann. §11-13R-3(b)(10) (West 2014).

WEST VIRGINIA SUPREME COURT OF APPEALS

CASE LAW

“While a grammatical analysis may be a useful tool in interpreting a statute, it is not controlling, and it will not justify an interpretation that is contrary to the intent of the Legislature.” Davis Mem'l Hosp. v. W. Va. State Tax Com'r, 222 W. Va. 677, 686-87, 671 S.E.2d 682, 691-92 (2008).

WEST VIRGINIA OFFICE OF TAX APPEALS

CONCLUSION OF LAW

In order for an activity to be considered research and development, pursuant to West Virginia's Strategic Research and Development Tax Credit, it must be done for the purpose of revealing new facts, theories, or principles or increasing scientific knowledge.

WEST VIRGINIA OFFICE OF TAX APPEALS

CONCLUSION OF LAW

The activities listed in the Petitioners' tax credit application were not done for the purpose of revealing new facts, theories, or principles or increasing scientific knowledge.

WEST VIRGINIA OFFICE OF TAX APPEALS

CONCLUSION OF LAW

The activities listed in the Petitioners' tax credit application were not systematic scientific, engineering, or technological study and investigation, based upon the common ordinary meaning of the word systematic.

TAXATION

WEST VIRGINIA OFFICE OF TAX APPEALS

HEARING PROCEDURES

In proceedings before the West Virginia Office of Tax Appeals the burden of proof is upon the Petitioner. *See* W. Va. Code Ann. §11-10A-10(e) (West 2010).

WEST VIRGINIA OFFICE OF TAX APPEALS

CONCLUSION OF LAW

The Petitioners have not met their burden of showing that the Tax Commissioner's denial of the requested tax credit was contrary to West Virginia law, clearly wrong or arbitrary and capricious.

FINAL DECISION

In May of 2012, the Petitioner A¹ filed an application for West Virginia's Strategic Research and Development Tax Credit, pursuant to West Virginia Code Section 11-13R-1 *et seq.*

¹ The record is not entirely clear as to the relationship between the two Petitioners. What is clear is that both entities received documents from the Tax Commissioner that they felt were appealable. First, Petitioner A, received a letter from the Tax Commissioner's General Counsel, dated May 25, 2012, stating that the credit had been denied. Then,

Interestingly, the tax credit application, does not contain a line for the amount of credit sought, instead it asks for information regarding the Taxpayer's research and development expenditures. On June 4, 2012, the Tax Account Administration Division of the West Virginia State Tax Commissioner's Office (Tax Commissioner or Respondent) issued a denial of the requested tax credit. This June 4 notice denied a credit of \$_____ and stated that the Taxpayer's balance due to the West Virginia Tax Department, as of that date, was \$_____. This denial identified the Taxpayer who requested the credit as Petitioner A, but it was sent to Petitioner B.

Thereafter, on July 23, 2012, both petitioners A and B timely filed two Petitions with this Tribunal, the West Virginia Office of Tax Appeals. *See* W. Va. Code Ann. §§11-10A-8(1); 11-10A-9 (West 2010).

Subsequently, notice of a hearing on the petitions was sent to the Petitioners, and a hearing was held in accordance with the provisions of West Virginia Code Section 11-10A-10, after which the parties filed legal briefs. The matter became ripe for a decision at the conclusion of the briefing schedule.²

FINDINGS OF FACT

1. The Petitioners are limited liability companies located in another State.
2. In October of 2009, the Petitioners entered into a contract with Company X to provide Petitioner A services to a gas well that Company X was drilling in a County in West Virginia. In layman's terms, the Petitioners were to lay pipeline to transport the natural gas to a processing plant.

on June 4, 2012, the Tax Account Administration Division issued a denial of business tax credit to Petitioner B. This is apparently why both entities each filed an appeal with the Office of Tax Appeals.

² By the time of the evidentiary hearing in this matter, the parties agreed that the only issue currently to be decided by this Tribunal is whether the work done qualifies for the research and development tax credit. The parties further agree that the question of which entity would receive the credit and in what amount will be addressed, if necessary, after the threshold question is decided.

3. Because the Petitioners were newly created entities at the time they executed the contract with Company X, this work in West Virginia was the first job they had undertaken.

4. During the performance of the contract, the Petitioners encountered various unexpected problems with weather, topography and the makeup of the gas produced by the well. These problems were new to the employees of the Petitioners, despite the fact that many of these employees had years of experience in laying pipeline.

5. These unforeseen problems included, rocky terrain, which affected the temperature of the gases and water flowing through the pipe, an unusual amount of rain, steep slopes, which made ditch digging difficult.

6. The Petitioners attached an addendum to their tax credit application. This addendum listed the activities which the Petitioners characterized as research and development and was utilized by the parties during the evidentiary hearing. The addendum identified the hillside terrain where the pipeline was to be laid as creating the difficulties and stated:

- a. Designing unique mats that would work on a 45-degree slope.
- b. Cutting off the tops of foothills to create a path for the pipeline.
- c. Designing and building special access areas from the closest road to move the equipment on petitioner's Right-of-Way to construct the pipelines, as the existing bridges were not strong enough to support the vehicles equipment. This was further exacerbated as there are no county roads in the area of construction. Consequently, for Petitioner to course adhere to the West Virginia laws that require a licensed lead and follow-up vehicle for large, heavy equipment, the Company had to create and execute transportation plans that were new to Petitioner and its consultants.
- d. Utilizing a bulldozer rigged to steel cables to connect to other bulldozers and track hoes winched together to dig ditches for the pipelines.
- e. The utilization of unique x-ray and inspection processes due to parallel condensate and natural gas pipelines being laid in the same ditch.

This limited the quantity and quality of human resources both internal and external to Petitioner to provide these services.

e. Due to long stretches of two pipelines being laid in the same ditch, the welding had to be performed in the ditch versus above the ditch and then lowered into the ditch, which is the industry standard. This led to new welding techniques and utilizing newly designed equipment to accomplish this welding situation.

f. The design and development of custom designed 'Marukas' or flat-bedded open-bed trucks with barber tools welded in so that they can be utilized on the side of steep hills.

g. Due to coal mine subsidence concerns, Petitioner specifically uses pigs in small sections versus the typical entire line. This was and is a new issue to design, engineer and operate for Petitioner and its outside contractors.

h. Construction issues arose due to: a.) side-hill cuts; b.) erosion control; c.) hundreds of springs underground, so every ditch and every digging area had to deal with different water issues; d.) large numbers of bedrock and impermeable clays that had to be dug through to lay pipelines; and e.) thin soil covering in many areas (sometimes as little as 12 inches.) Each of these issues required testing, iterative hypothesis testing and unique engineering designs to accommodate ever-changing environmental and water fact patterns. New designs were constantly required specifically as the amount of rain encountered and ever-changing underground water encroachment created engineering issues not before experienced by any of the employees and their construction consultants.

i. Due to topography and weather issues/concerns, Petitioner had to bury some segments of its pipeline up to 20 feet deep versus the typical 3 feet. As an example, in December 2011, there were 24 inches of mud in most areas of construction.

j. While some of the construction issues have been faced by other pipeline companies, all of the afore-mentioned issues were new to Petitioner employees and their outsourced construction and engineering resources.

k. Prior to Petitioner's gathering and processing infrastructure in this area, three other companies had each attempted to construct similar pipelines in two Counties in West Virginia but abandoned the projects due to the afore-mentioned technical difficulties.

7. At the evidentiary hearing, the Petitioners' witness testified regarding other activities that they considered research and development. Specifically, he testified regarding problems with the pressure of the gas coming out of the well, which necessitated installing blowcases to rectify. The Petitioners' tax credit application did not mention the installation of these blowcases.

8. The Tax Commissioner, upon reading the Petitioners' application, responded in writing, stating that the activities described did not appear to meet the definition of research and development.

DISCUSSION

The Strategic Research and Development Tax Credit are contained in Article 13R of Chapter 11 of the West Virginia Code. Section 2 of Article 13R identifies the Legislature's purpose in creating the credit, and says in part that it is designed to "encourage research and development in this state and thereby increase employment and economic development" W. Va. Code Ann. §11-13R-2 (West 2010). The amount of the credit is "the greater of: (1) Three percent of the annual combined qualified research and development expenditure; or (2) Ten percent of the excess of the annual combined qualified research and development expenditure over the base amount." W. Va. Code Ann. §11-13R-5 (West 2014). Finally, Section 3 of Article 13R defines research and development as:

"Research and development" means systematic scientific, engineering or technological study and investigation in a field of knowledge in the physical, computer or software sciences, often involving the formulation of hypotheses and experimentation for the purpose of revealing new facts, theories or principles or increasing scientific knowledge which may reveal the basis for new or enhanced products, equipment or manufacturing processes.

(A) Research and development includes, but is not limited to, design, refinement and testing of prototypes of new or improved products or equipment or the design, refinement and testing of manufacturing processes before commercial sales relating thereto have begun. For purposes of this section, commercial sales include, but is not limited to, sales of prototypes or sales for market testing.

W. Va. Code Ann. §11-13R-3(b)(10) (West 2014).

At the outset, we need to dispense with the Petitioners' argument regarding the blowcases. The purpose of all hearings before the Office of Tax Appeals is to determine errors made by the Tax Commissioner. Obviously, the Tax Commissioner cannot have made an error regarding the blowcases, when he was never informed by the Petitioners that they considered their design and installation to be research and development. For the purposes of this decision, we will consider this dispute to involve only the activities listed in the Petitioners' tax credit application.

Before we discuss whether the Petitioners are entitled to the requested credit, a review of the arguments of the parties is necessary. This is due to an apparent modification of the Petitioners' argument between their initial brief and their reply brief. Initially, the Petitioners seemed to be arguing that the clause, "for the purpose of revealing new facts, theories or principles or increasing scientific knowledge" in Subsection (b)(10) only applied to that portion of the Subsection relating to "the formulation of hypotheses and experimentation". The Petitioners argued as such because West Virginia Code Section 11-13R-3 was amended in 2011 and the comma after experimentation was removed. As a result, the Petitioners argued: "by removing the comma after 'experimentation,' the Legislature intended to have the 'for the purpose of revealing new facts . . . ' clause applies only to the non-discretionary 'often involving the formulation of hypotheses and experimentation' language." *See* Petitioners' Initial Brief at p.

30. The Tax Commissioner argued that while grammatical analysis may be a useful tool, it is not controlling and cited two West Virginia Supreme Court of Appeals' cases as standing for that proposition.

In their reply brief, the Petitioners modified their argument and stated that "whether the phrase, 'for the purpose of revealing new facts, theories or principles or increasing scientific knowledge,' is a parenthetical element of the definition or a restriction on the definition is moot, as applied to the facts of this case. *See* Petitioners' Reply Brief at p. 5.

If we take the Petitioners at their word, and render the debate about the removed comma moot, then the Tax Commissioner must prevail. Despite the Petitioners' contention in their reply brief, their activities in West Virginia were not "geared towards" the purpose of revealing new facts, theories or principles or increasing scientific knowledge. Their activities were geared towards getting the pipeline put into the ground as quickly and cheaply as possible.

JUDGE POLLACK: That's not my question. My question is, were there never times where you would show up --- you know, after the well has been dug and now they've bid on who they want to do their midstream, you show up and things aren't exactly like the midstream company thought they were going to be?

MR. C: They're never exactly. But they're always solvable solutions within the own expertise that you have within a company. Okay?

JUDGE POLLACK: And how are these solvable solutions in West Virginia any different than the solvable solutions in Texas, Louisiana, or Oklahoma?

MR. C: Well, the pipeline is flowing; right?

JUDGE POLLACK: Right.

MR. C: It's solved. The question is, how much cost and expense did it take to solve them. And why couldn't people that had solved them a hundred other times before --- a day solution on I need the right size of a piece of equipment or change something out and it's

solved? You know, why couldn't we solve it in 24 hours? Why couldn't anybody solve it in ---? You know, you got to have a ---.

JUDGE POLLACK: These were more ---

MR. C: If you ---.

JUDGE POLLACK: --- unique problems?

MR. C: If you don't have an appreciation for, you know, a 20-year engineer sitting there in a room trying to figure this out and think that, you know, you're all --- you know, you lost everything you know or, you know, whatever you know is not applicable and you got to ---. You know, that's what was going on here. It's like guys, this isn't like that, this isn't like that, we've done --- yeah, we've tried that before, but here's what ---. They're using every bit of their experience to find success.

JUDGE POLLACK: Right. In layman's terms, somebody's scratching their head saying this is a new one on me, Joe, I'm going to have to sit and figure this; right?

MR. C: Right. I've got a problem to solve, I've got to find some way to design, to ---. You know, failure is not an option. We got to solve this and we got to keep moving. And, you know, ours was exacerbated [sic] by the acceleration of --- we got a timeline and we got to continue to work through it. And so it was solving as we go.

See Transcript at p. 117-118.

A review of the work done, based upon the tax credit application, coupled with the testimony at hearing (of which the excerpt above is just one example) clearly shows the Petitioners' purpose, and it was not to reveal new facts, theories or principles or to increase scientific knowledge. To be clear, we understand that the Petitioners may have discovered new facts about laying pipelines in Appalachia while they solved their dilemmas; however, to obtain the tax credit they must have set out with a specific purpose in mind.

Interestingly, almost as soon as the Petitioners state that the argument about the removed comma is moot, they back-pedaled, somewhat, and state, "[F]urthermore, the Respondent does

not dispute that the Petitioners' activities constituted 'systematic scientific, engineering or technological study and investigation in a field of knowledge in the physical, computer or software sciences . . . ' Consequently, the Petitioners' activities qualify as 'R&D' for purposes of the R&D Act." *See* Petitioners' Reply Brief p. 5. Here, the Petitioners seem to be arguing that the removed comma **does** matter, and as a result, their purpose in doing the work **does not** matter, as long as they engaged in systematic scientific, engineering or technological study and investigation in a field of knowledge in the physical, computer or software sciences. If that is, in fact, what the Petitioners are arguing, we are still unpersuaded.

For over one hundred years, the West Virginia Supreme Court of Appeals has directed that significance and effect must, if possible, be given to every section, clause, word, or part of a statute. *See e.g. Young v. Apogee Coal Co., LLC*, 232 W. Va. 554, 753 S.E.2d 52 (2013); *Old Dominion Bldg. & Loan Ass'n v. Sohn*, 54 W. Va. 101, 46 S.E. 222 (1903). Another well-settled rule of statutory interpretation is that "undefined words and terms used in a legislative enactment will be given their common, ordinary, and accepted meaning." *Fountain Place Cinema 8, LLC v. Morris*, 227 W. Va. 249, 253-54, 707 S.E.2d 859, 863-64 (2011). When we apply these rules to our interpretation of the definition of research and development, the Petitioners' argument fails on the first word, "systematic." Systematic is defined as "[D]one or acting according to a fixed plan or system; methodical." <http://www.oxforddictionaries.com>. Rather than showing systematic study and investigation, the testimony in this matter shows the opposite, namely that as problems arose in laying the pipeline, the Petitioners undertook a series of ad hoc actions, each with the goal of overcoming the problem as expediently and cheaply as possible.

- **ATTORNEY MUDRINICH:** And you didn't wait for the rain to stop, why?
MR. C: We had deadlines and requirements to finish the pipelines and deliveries in a certain amount of time. *Transcript p. 73*

- **MR. C:** But we had different drivers that they had, you know, in terms of timing and when the pipes had to go in to be in compliance with our contracts. So we had to find ways to solve some of these issues that they had typically avoided in their companies. And they avoided them because of cost and some of these very issues, which I think as we get into this --- there were certainly cost implications to our need to go ahead and move forward with the projects. *Transcript p. 17*
- **MR. C:** Yeah, I think postmortem, if you looked at what we had planned on spending, it was just over \$_____. And I think I said we had spent close to \$_____. So the system costs us over \$_____ more than what we had anticipated. And you know, you kind of go back to breaking back, well, what were the drivers related to that. And, you know, a substantial portion --- it was kind of split between construction related activities that we hadn't planned on and didn't foresee in the beginning. And then a lot of the dynamics around pushing this kind of a new breed of liquid through the line, solving those issues was probably the other part of that spend --- that overspend. *Transcript p. 35*
- **PETITIONER ATTORNEY:** In a normal situation, the company would just stop during these and wait until it dried out, and then start working on it. But you didn't have that option, so you had to ---?
MR. C: We just had to keep trying to come up with, you know, different ways to solve the issue. *Transcript p. 52.*
- **PETITIONER ATTORNEY:** Now, one of the things you mentioned was that you had to keep working through the winter, not only because it needed to get in to take this production, but also because of Indiana bats environmental regulations?
MR. C: Yeah, I know that was circling at the same time and had an influence on what we had to do when and when we had to get it done. *Transcript p. 52*
- **JUDGE POLLACK:** And would it be fair to say that everything we're here talking about today was of a similar vein, problems that were encountered, people --- some employees of Petitioner A, some other people putting their heads together to figure out a solution to the problem?
MR. C: Sure. I mean it's a process of understanding what your issues are and what's the most likely beneficial, economic solution to it.
JUDGE POLLACK: And this was mostly done on the ground as the problems occurred; correct?
MR. C: It's in the field.
JUDGE POLLACK: Yeah.
MR. C: Yeah, that's your lab. You know, you're not sitting in a --- logging different scenarios in a book and test tubes and ---. I mean it's out in the field. It's

dirty, it's ugly, it's --- you know? But you've got to solve the same series of problems in that environment. *Transcript p. 87-88*

In summation, we are unconvinced by both of the Petitioners' arguments. We rule that research and development, pursuant to West Virginia Code Section 11-13R-3(b)(10) involves systematic scientific, engineering or technological study and investigation in a field of knowledge in the physical, computer or software sciences for the purpose of revealing new facts, theories or principles or increasing scientific knowledge. If we are wrong, and the lack of a comma after the word experimentation is controlling, we also rule that the Petitioners were not engaged in systematic scientific, engineering or technological study. By putting the word "systematic" in the definition of research and development, the Legislature limited the activity to methodical actions based upon a fixed plan or system. Clearly, the drafters did not intend for ad hoc actions, such as undertaken by the Petitioners in this matter to be eligible for the tax credit, because for all intents and purposes, ad hoc is an antonym to systematic.³ When Petitioner B and Petitioner A were formed, the members and employees had extensive pipeline experience in five other States. No one in the companies said "we want to broaden our area of operations, so we must research the problems encountered when one lays pipeline in colder climates, in the jungle, over mountains, or underwater." That presumably could lead to systematic scientific, engineering or technological study and investigation in a field of knowledge in the physical, computer or software sciences, as those terms are used in West Virginia Code Section 11-13R-3. Instead, the Petitioners approached each problem with only one goal, keeping the project moving. One can apply this logic to any of the activities listed in the Petitioners' application. For example, when the Petitioners attached one bulldozer by cable to another, they were not

³ Ad hoc: "formed, arranged, or done for a particular purpose only." <http://www.oxforddictionaries.com>.

following some fixed plan or system to test how steep a slope a bulldozer can operate on; it was done for a particular purpose, to get the ditch dug and the pipe in the ground. When the unforeseen problems arose they set out to solve the problem in front of them at that moment, which is not research and development under West Virginia law.

CONCLUSIONS OF LAW

1. It is the duty of the Tax Commissioner to see that the laws concerning the assessment and collection of all taxes and levies are faithfully enforced. *See* W. Va. Code Ann. §11-1-2 (West 2010).

2. In 2002 the West Virginia Legislature created the Strategic Research and Development Tax Credit, which was designed to “encourage research and development in this state and thereby increase employment and economic development” W. Va. Code Ann. § 11-13R-2 (West 2010).

3. The amount of the credit is “the greater of: (1) Three percent of the annual combined qualified research and development expenditure; or (2) Ten percent of the excess of the annual combined qualified research and development expenditure over the base amount.” W. Va. Code Ann. §11-13R-5 (West 2014).

4. Section 3 of Article 13R defines research and development as: “systematic scientific, engineering or technological study and investigation in a field of knowledge in the physical, computer or software sciences, often involving the formulation of hypotheses and experimentation for the purpose of revealing new facts, theories or principles or increasing scientific knowledge which may reveal the basis for new or enhanced products, equipment or manufacturing processes.” W. Va. Code Ann. §11-13R-3(b)(10) (West 2014).

5. “While a grammatical analysis may be a useful tool in interpreting a statute, it is not controlling, and it will not justify an interpretation that is contrary to the intent of the Legislature.” Davis Mem'l Hosp. v. W. Va. State Tax Com'r, 222 W. Va. 677, 686-87, 671 S.E.2d 682, 691-92 (2008).

6. In order for an activity to be considered research and development, pursuant to West Virginia's Strategic Research and Development Tax Credit, it must be done for the purpose of revealing new facts, theories or principles or increasing scientific knowledge.

7. The activities listed in the Petitioners' tax credit application were not done for the purpose of revealing new facts, theories or principles or increasing scientific knowledge.

8. The activities listed in the Petitioners' tax credit application were not systematic scientific, engineering or technological study and investigation, based upon the common ordinary meaning of the word systematic.

9. In proceedings before the West Virginia Office of Tax Appeals the burden of proof is upon the Petitioner. *See* W. Va. Code Ann. §11-10A-10(e) (West 2010).

10. The Petitioners have not met their burden of showing that the Tax Commissioner's denial of the requested tax credit was contrary to West Virginia law, clearly wrong or arbitrary and capricious.

DISPOSITION

WHEREFORE, it is the final decision of the West Virginia Office of Tax Appeals that the June 4, 2012, denial of the requested tax credit should be and hereby is **AFFIRMED**.

WEST VIRGINIA OFFICE OF TAX APPEALS

By: _____

A. M. "Fenway" Pollack
Chief Administrative Law Judge

Date Entered